THE TAX CONSEQUENCES FOR A SELLER (ALSO BRIEFLY COMMENTING FROM THE PERSPECTIVE OF THE PURCHASER) WHEN CONTINGENT LIABILITIES ARE TRANSFERRED IN A SALE OF A BUSINESS AS A GOING CONCERN WITH SPECIFIC REFERENCE AND EVALUATING *INCOME TAX CASE NO. 1839* (SOUTH GAUTENG TAX COURT)

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DECLARATION

I, Dewald Pierre Rossouw, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgments indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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SUMMARY

The selling of a business as a going concern can have various tax consequences for both the seller and the purchaser. This is so whether the purchase price is determined with reference to the net asset value, i.e. gross assets less liabilities, or not. Accounting liabilities are always part of a business and therefore part of a business sales contract. The basic transaction is normally that some or all of the assets of the business are transferred to the purchaser who also assumes all or some of the liabilities of the business. The liabilities transferred may include various accounting provisions.

To be more specific, if for example an bonus provision is due to the seller's employees and the provision is set-off in determining the sale price, has these cost been incurred in the production of income on the seller's side? If not, can the purchaser claim the deduction when they incur? Is the receipt of this amount capital or revenue in the hands of the purchaser? Uncertainty exists on the tax treatment of the transfer of these contingent liabilities.

A taxpayer pays tax on his taxable income, which is calculated in terms of the Income Tax Act 58 of 1962 ('the Act'). In determining taxable income, a taxpayer is entitled to certain deductions which are, in general, covered by the general deduction formula. Unless expenditure qualifies for a deduction under one of the various sections which provides for specific deductions, an expense is only deductible if it complies with the requirements laid down in section 11*(a)* and is not a prohibited deduction under section 23.

Whereas the denial of a deduction in the hands of the seller may be debatable, the practice of a double non-deduction for the seller and the purchaser is unsatisfactory.

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1 INTRODUCTION

1.1 Background

As the tax consequences of a sale agreement will depend on the way the agreement is structured, it is of the utmost importance that potential buyers and sellers of a business familiarize themselves with the different tax implications that may flow from the sale (Olivier, 2007:600).

Companies prepare their financial statements within the strict rules and regulations of Generally Accepted Accounting Practice ('GAAP'). Companies should reflect their financial status accurately and are therefore required to include any probable expense related to that year of assessment. These 'probable expenses' are called provisions and have been the source of many different opinions and views.

In the Tax Planning article, Keirby-Smith (1996a:2) highlights some of the dilemmas that are usually associated with accounting provisions:

> The challenges facing the accountant in the form of provisions have extended to the offices of the Commissioner for Inland Revenue, with the result that numerous organisations have been on the receiving end of investigations by Inland Revenue, which have resulted in the add-back of provisions previously claimed and allowed for normal tax.

Considering the number of sales of businesses which take place in South Africa every year, it is extraordinary that there is only one (reported) decision of the tax court, i.e. *Income Tax Case No. 1839*[1], dealing with the question of how a provision for future expenditure (contingent liabilities) in the business, taken over by the purchaser, must be dealt with for normal tax purposes. Simply stated, the correct treatment will always depend on the type of provision and the actual set of facts of the particular case. It is true that these questions have been analysed on many occasions. Yet, it seems that many well-respected tax specialists (including some within the South African Revenue Service ('SARS')) have come to different conclusions, making it all the more surprising that the principles have not previously come before the courts (Clegg 2010a:19).

[1] (2009) 72 SATC 61

1.2 Objectives and approach (layout of the study)

Chapter two introduces the general principles that determine the deductibility of an expense.

Chapter three of this thesis, and also the main focus of the study, considers the reported *ITC 1839,* decided in the South Gauteng Tax Court on 17 March and 14 May 2009. The court had to consider whether tax-deductible expenditure had been incurred in paying the purchaser to assume the obligation to pay contingent liabilities. The court found that the deduction of the relevant amount was not allowable in terms of the the Act.

Arguments from the taxpayer (hereinafter seller, appellant or taxpayer) and SARS (hereinafter Commissioner, respondent or SARS) will be discussed, focusing on the taxpayer's side. The relevant legislative provisions and other cases will be referred to and discussed, but only to the extent as required by the ambit of this study. English and Australian cases that are relevant and central to the study will also be discussed.

Chapter four will consider the treatment of other relevant contingencies not discussed in the ITC case and **chapter five** will briefly highlight the position of the purchaser. **Chapter six** will, in a concise manner, discuss recoupments and **chapter seven** will look into the importance of the wording of contracts.

The primary objective of this study is to concentrate on *ITC 1839* and the reasoning of the counsels and the judge. The secondary objectives will be as discussed in chapter two, four, five, six and seven.

1.3 Research methodology

The research methodology used was the historic method. A review of the literature was undertaken to determine the income tax consequences during the sale of contingencies.

1.4 Limitation of scope of study

This study is from the perspective that the seller and the purchaser are both companies and incorporated, established or formed in the Republic of South Africa ('RSA') or which has its place of effective management in the RSA. A going concern is defined as the net asset value (assets less liabilities) of the business. The purpose is not to deal with all tax issues relevant to the transfer of a business. Also, capital gains tax implications do not fall within the scope of this study.

2 OVERVIEW OF THE BASIC PRINCIPLES

2.1 General deduction formula

Certain sections of the Act determine the deductibility of an expense. To be classified as deductible, expenditure must comply with the requirements as laid down in section 11*(a)* and not be prohibited under section 23. The combined working of these sections of the Act is commonly known as the general deduction formula (Keirby-Smith 1996a:2).

Section 11*(a)* of the Act deals specifically with the treatment of expenses incurred, in the carrying on of any trade. 'Trade' is defined in section 1 of the Act as follows:

> **"trade"** includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature.

Section 11*(a)* of the Act lays down the requirements regarding expenses:

> **11. General deductions allowed in determination of taxable income**.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

Accordingly expenses must be actually incurred (in the specific year of assessment), in the production of income and also be not of a capital nature to qualify for a deduction in terms of section 11*(a)* of the Act. If all of these requirements are complied with, the taxpayer will be entitled to a deduction for income tax purposes.

Section 23 of the Act covers, in its entirety, deductions that are prohibited in the determination of taxable income. The subsections that will be focused on in this study are section 23*(e)*, 23*(f)* and 23*(g)* of the Act because they are specifically mentioned in *ITC 1839*. Section 23*(e)*, 23*(f)* and 23*(g)* of the Act reads as follows:

> **23. Deductions not allowed in determination of taxable income.**—No deductions shall in any case be made in respect of the following matters, namely—
>
> (*e*) income carried to any reserve fund or capitalized in any way;
>
> (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one; and
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.

2.2 General deduction formula – actually incurred

Relevant court cases will be briefly discussed to clarify the concept of 'actually incurred' as set out in section 11*(a)* of the Act.

Firstly, expenses actually incurred and paid in the same tax year are deductible under section 11*(a)* of the Act. However, expenses incurred in one financial year with payment due in the following financial year are also deductible in the first year.

Two court cases confirm this deduction:
In *Port Elizabeth Tramway Co Ltd v CIR*[2], it was found that an expense was actually incurred in one financial year, although no payment was made for this expense at the time. The commentary from Watermeyer AJP in the abovementioned case:

> But expenses "actually incurred" cannot mean, 'actually paid'. So long as the liability to pay them actually has been incurred they may be deductible.

In the *Caltex Oil* case[3], it was held that 'expenditure actually incurred' does not necessitate the transfer of payment during the particular year of assessment. Botha JA submitted that:

> It is in the tax year in which the liability for the expenditure is incurred and not in the tax year in which it is actually paid (if paid in a subsequent year), that the expenditure is actually incurred for the purposes of s 11(*a*).

What can be derived from these two cases is that 'actually incurred' therefore qualifies the expenditure to be due and payable. However, even when expenditure is incurred within a particular assessment year, the payment can be made in a subsequent year.

Expenses that are conditional upon the outcome of future events cannot be deducted, as discussed in the following three court cases.

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2 1936 CPD 241 8 SATC 13 at 15
3 Caltex Oil (SA) Ltd v SIR 1975 (1) SA 665 (A); 37 SATC 1 at 12

In *Nasionale Pers Bpk v KBI*[4] Hoexter JA expanded upon the term 'actually incurred':

> Die vereiste dat die onkoste "werklik aangegaan" moet wees, het egter tot gevolg dat moontlike toekomstige uitgawes wat bloot as waarskynlik geag word nie ingevolge art 11(*a*) aftrekbaar is nie. Alleen onkoste ten opsigte waarvan die belastingbetaler volstrekte en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar afgetrek word.

In *Edgars Stores Ltd v CIR*[5], Corbett JA added:

> …it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(*a*) from income returned for that year. The obligation may be unconditional ab initio or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied).

In *CIR v Golden Dumps (Pty) Ltd*[6], similar conclusions were made:

> A liability is contingent where there is a claim which is disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay. …The taxpayer could not properly claim the deduction in that tax year, and the Receiver of Revenue could not, in the light of the onus provision of s 82 of the Act, properly allow it.

2.3 General deduction formula – in the production of income

The *Port Elizabeth Electric Tramways* case was one of the first cases in which the meaning 'in the production of income' was considered. Expenditure must be closely linked to the business operation, and then the expense will be incurred 'in the production of income' and deductible in terms of section 11*(a)* of the Act.

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[4] 1986 (3) SA 549 (A) 48 SATC 55 at 69

[5] 1988 (3) SA 876 (A) , 50 SATC 81 at 90

[6] 1993 (4) SA 110 (A), 55 SATC 198 at 206 - 207

The principles laid down in *Port Elizabeth Electric Tramways* case are frequently used in later cases that discuss the term 'in the production of income'. Therefore only one later case will be discussed, as this is adequate to identify the meaning of 'in the production of income'.
In *Port Elizabeth Electric Tramways*, the judge held that[7]:

> …all expenses attached to the performance of a business operation bona fide performed for the purposes of earning income are deductible whether they are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

It is not necessary that each item of expenditure should directly or indirectly lead to the production of income as no expenditure, strictly speaking, actually produces income. This was observed in *Port Elizabeth Electric Tramways* (at page 13):

> Taking these in turn, the words of statute are "actually incurred" not "necessarily incurred". The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure.

One needs to look at a business as a whole set of operations all directed towards producing the income when establishing whether an expense has been incurred in the production of income (at page 15).

If it were necessary to establish a strict causal nexus between the expenditure and the production of income, one would be investigating the business efficacy of the taxpayer, which is not the function of the Income Tax Act or the Commissioner (*ITC 1600*[8]).
Income is produced by a series of actions, attendant upon which are expenses, which are deductible if they are so closely linked to such acts as to be regarded as part of the cost of performing them. The other two requirements of section 11*(a)* of the Act must have also been complied with for an expense to be deductible.

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[7] Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13 at 13

[8] ITC 1600, 1995 58 SATC 131

In *Sub-Nigel ltd v CIR*[9] the court held that the fact that no income is actually earned is irrelevant as long as the expense is incurred for the purpose of earning income. The purpose of the expenditure must be considered to establish whether the expense is incurred to earn income, and if so, the requirement of 'in the production of income' is complied with.

2.4 General deduction formula – not of a capital nature

To distinguish between a capital and a non-capital expenditure, the purpose of the expenditure must be considered. Case law lays down tests for distinguishing between capital and non-capital expenditures.

The true nature of the transaction should be examined to determine the capital or revenue nature of the attendant expenditure. In *New State Areas v CIR*[10], Watermeyer CJ summarised a test as:

> The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.

Various tests or guidelines have been enounced by the courts to determine or test the revenue or capital nature of expenditure. None of these tests is, however, absolutely conclusive, and each individual case should be considered on its own unique facts and circumstances.

If expenditure incurred otherwise qualifies as a deduction but is capital in nature, the expenditure cannot be deducted in terms of section 11*(a)* of the Act.

[9] 1948 (4) SA 580 (A), 15 SATC 380
[10] 1946 AD 610 14 SATC 155 at 170

2.5 Conclusion

As noted in IFRS[11], accounting provisions may be created under IAS 37 which forms part of GAAP. Because accounting provisions are usually 'probable' expenses that are provided for, the general deduction formula as set out above must be utilised to determine if these accounting provisions are deductible for income tax purposes (Keirby-Smith, 1996a). Keeping chapter two in mind, the next chapter will discuss *ITC 1839* in more detail.

3 *INCOME TAX CASE NO. 1839*

3.1 Introduction

In the *ITC 1839* (at page 61) case the South Gauteng Tax Court had to consider whether the taxpayer company, the seller of a retail business, was entitled to deduct from its taxable income in terms of section 11*(a)* of the Act the amounts of three underlying contingent liabilities that were to be taken over by the purchaser in terms of the sale agreement of the business as a going concern.

The purchase price was defined in the sale agreement as 'the amount equal to the sum of R800 million and the rand amount of the liabilities'. An annexure to the sale agreement arrived at the net amount owing of R800 million from the gross purchase price of R1.1 billion, the difference was represented by the value of assets of R1.1 billion less liabilities of approximately R311 million. Included in the R311 million, the appellant had made certain accounting provisions, contingent liabilities, in respect of post-retirement medical aid benefits for the appellant's staff; long term bonuses for such staff and obligations to carry out repairs in respect of certain leases.

As at 1 March 2004 these provisions were still contingent. These provisions, which the purchaser had agreed to assume, as part of the sale, amounted to R17 million.

The respondent had issued an additional assessment in respect of the taxpayer's 2004 year of assessment in which he had disallowed an amount of roughly R23 million which had been claimed by the appellant as a deduction in respect of the aforementioned provisions.

[11] International Financial Reporting Standards (IFRSs), Volume 1B, 2008/2009, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), Objective paragraph of IAS 37

Chapter three will explore the *ITC 1839* case. It is also understood that this case is on appeal to the Supreme Court of Appeal.

3.2 Background on the *ITC 1839* contingencies (i.e. post employment benefits, bonus/leave payments and repairs and maintenance of capital assets)

POST EMPLOYMENT BENEFITS

Post employment medical care benefit is discussed as this is one of the contingencies disallowed in *ITC 1839*. An expense may be deductible for income tax purposes if the requirements of section 11(*a*) of the Act are complied with.

The expense must be actually incurred, in the production of income and must not be of a capital nature. A provision created for post employment benefits is therefore not deductible under section 11(*a*) of the Act as it usually represents actuarial risk, if the actuarial calculations indicate that the employer's obligation may have increased from the original calculations, and not an amount actually incurred (Kroukamp 2006:29).

BONUS/LEAVE PAYMENTS

It is assumed (and understood from the case) that the provision taken over was created to provide for the seller's contingent liability to pay long term bonuses to staff that are still in the seller's employment before the sale of the business.

The following paragraphs are Olivier's (2007:614-617) view on bonus and leave payments:

Position of the seller

The seller will only be entitled to make use of a section 11(*a*) deduction for expenditure incurred on bonuses and leave if an absolute and unconditional obligation to pay existed during the year of assessment. Conditional future expenditure cannot be deducted, as there is no absolute and unconditional liability to pay it.

Section 23E(2) of the Act specifically deals with leave payments and provides that an employer is entitled to deduct leave pay only in the year of assessment in which the leave pay is actually paid or has become due and payable. To be deductible, the employer has to pay or incur an absolute and unconditional liability to pay. Whether he has such a liability at any point of time will depend on the facts of each case.

If the seller's year of assessment ends before the payment or accrual date of the bonuses or leave payments, he will not be entitled to any deduction as the expenditure would not have been 'actually incurred'. There may be instances where, at the end of a tax year, an employer has an absolute and unconditional liability for a portion of the bonus or leave payments, despite the fact that the date for payment has not yet arrived. For example, if, in terms of the employment contracts, the employees become entitled to a pro rata portion of the annual bonus or leave payment on the completion of each month's service, then at the end of the employer's tax year the employer will have an absolute and unconditional liability for a portion of the bonus or leave payments and will be entitled to deduct these amounts.

The balance of provision, for future conditional liabilities, has to be added back for tax purposes. As section 23B(3) prohibits a deduction under section 11(*a*), if a specific section deals with the deductibility of the expenditure, as s 23E does, the seller cannot deduct expenditure incurred on leave pay under section 11(*a*).

The possibility exists that if the seller claims a deduction for an actual liability under section 23E and the purchaser actually pays the creditors, there may be a recoupment under section 8(4)(*m*) in the hands of the seller equal to the amount of the obligation from which the seller was relieved. This will only be the case if it can be argued that the effect of payment by the purchaser discharges the obligation, and the seller is released from the obligation for no consideration.

On this assumption, any payment made by the seller in return for being released from the obligation has to be taken into account. If the seller did not make a specific payment to the purchaser for assuming future contingent liabilities, subsequently discharged by the purchaser, a recoupment may well arise. If, in return for the release of future contingent liabilities, a lower purchase price is accepted, it is doubtful whether this will be taken into account. The Commissioner can assess the seller on the basis that the whole of the deduction was recouped. It would then be up to the seller to prove that, although strictly speaking there was a recoupment, the economic effect or benefit of the recoupment is zero.

The seller should be in a position to prove to what extent the purchase price was lowered in return for the purchaser assuming the liability, as deducted by the seller[12]. If a specific amount was paid by the seller to the purchaser for the latter assuming future bonus or leave payments, the extent of the recoupment will depend on the amount paid. If the amount paid is less than the deduction claimed by the seller, the seller would have recouped the shortfall. From the seller's point of view, to avoid a possible recoupment once the purchaser pays the creditors, it is advisable to expressly pay the purchaser for assuming liabilities previously deducted by the seller[13].

If the seller paid the purchaser a specific amount for assuming bonus and leave obligations, he will only be entitled to a deduction under section 11(*a*), to the extent that he can prove that the expenditure was incurred in the production of income[14].

The seller should not, as an alternative arrangement, retain the obligation to make bonus or leave payments as he will not, after the take-over date, be entitled to a deduction as payments to erstwhile employees may not be regarded as incurred in the production of income or for the purposes of trade. It would be difficult to argue that the liability to pay the bonuses or leave payments results from the conditional liabilities incurred while carrying on his income-earning operations becoming unconditional. The condition would have been the employees concerned being still in the employment of the seller, which they will not be when the liability becomes unconditional.

Position of the purchaser

If the purchaser receives an amount as payment for assuming actual liabilities, it may be argued that he will be taxed on the receipt. On the assumption that the amount is indeed taxable a deduction under section 24C may be claimed. A deduction may also be claimed

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[12] To prove to what extent the purchase price was lowered is not always as straightforward as one would imagine; see below for further discussion on *ITC 1839*.

[13] Also refer to chapter five and six for a further brief discussion.

[14] In *ITC 1839* further issues were raised, with regards to the contingencies, namely: has there been expenditure actually incurred?; was the expenditure of a capital nature?; incurred for the purpose of trade? and whether not limited according to section 23(*f*) and (*g*).

under section 11(*a*) when the leave and bonus payments are actually incurred. The end result is that the purchaser will be taxed on that part of the amount not used to pay bonuses or leave.

If the purchaser (as is normally required) takes over the employment contracts of the employees pursuant to the purchase of the business and actually pays the bonuses or leave payments pursuant to its obligations under the contracts, the purchaser will be incurring the expenditure in the production of income. The Tax Court is currently of the view that a purchaser will be entitled to a section 11(*a*) deduction in circumstances where no economic loss was suffered as the purchase price was reduced to provide for the outstanding leave and bonus obligations. In unreported *case number 11107*, delivered by the Pretoria Tax Court on 29 April 2005, the court refused to accept the SARS view that the subsequent payment of the leave and bonus payments was of a capital nature. A different conclusion was reached by the Privy Council in *New Zealand in Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd*. It was held that expenditure incurred on the acquisition of the provisions/liabilities represents capital expenditure in the hands of the purchaser. The reason is that expenditure paid for the acquisition of assets is capital expenditure. In other words, the expenditure is more closely related to the income producing concern than to the income producing activities. The result is that subsequent discharge by the purchase of the obligation represents expenditure of a capital nature notwithstanding the fact that the original payment would have been of a revenue nature.

It is interesting to note that in *Case Number 11107* the court found that the expenditure incurred did 'not constitute money spent in creating or acquiring an income-producing concern, or in the acquisition by the taxpayer of the means of production, i.e. property, plant, tools, etc. which he uses in the performing of his income earning operations', whereas in *New Zealand Forest Research Institute* this was held to be the case. Clearly, where the payment is made as part of expenditure incurred in the acquisition of an income producing concern, the expenditure is of a capital nature and should not be deductible for income tax purposes.

Based on the reasoning of the court in this case, from the purchaser's point of view, it is not advisable to be paid for taking over of the obligations, but rather to accept a lower purchase price. In this situation the purchaser will in effect obtain a deduction for an expense for which he will not have had a taxable receipt or accrual nor will he have suffered any actual expense.

REPAIRS AND MAINTENANCE OF CAPITAL ASSETS

For the purposes of this discussion it is assumed that a provision is created for anticipated repairs to, and maintenance of, buildings and other capital assets which occur irregularly and are not the subject of any specific commitment at the take over date in the sale agreement.

The following paragraphs are Olivier's (2007:611-612) view on repairs and maintenance of capital assets:

Position of the seller

The seller will not be entitled to a deduction equal to the provision for anticipated repair and maintenance expenditure, as it will not have been actually incurred. In addition, a deduction is specifically prohibited by section 23(*e*) of the Act. As he will not have claimed a deduction, a recoupment will not arise under section 8(4)(*m*) where as a result of the sale the seller no longer has to effect the improvements.

If the seller pays the purchaser a specific amount as compensation for future costs on repairs, he may not be able to claim a deduction under section 11(*a*), as the expenditure will not be incurred in the production of income. The purpose of the expenditure is not to produce income, but to bring an end to trading activities[15]. If the seller can successfully argue that the purpose of the expenditure was to produce income in the form of the purchase price, which is partially taxable, then he will be entitled to a pro rata deduction.

The seller should not retain the obligation to repair or maintain the assets as he will not be entitled to a deduction for expenditure incurred. At the time the expenditure is incurred (i.e. at the time when the seller acquires an absolute and unconditional liability for the expenditure) the seller will no longer be using the assets for the production of income or for the purposes of trade.

[15] In *ITC 1839* it was also argued (respondent's counsel) that the purpose of the expenditure is not to produce income, but rather to bring an end to the trading activities.

Position of the purchaser

The purchaser will be entitled to deduct the expenditure once it is actually incurred, provided that it is incurred on repairs and not on improvements.

If the seller pays the purchaser a specific amount for assuming the liabilities, the purchaser will be taxed on the receipt or accrual. The purchaser should be entitled to a section 24C and, eventually, a section 11(*a*) deduction in the year of assessment in which the repairs are affected. The net result will be that the purchaser will be taxed on that portion of the payment which is not spent on repairs or maintenance.

From the purchaser's point of view it is advisable not to accept a specific amount as payment for the obligation to effect the repairs and maintenance (as their cost will, in any event, be deductible by him), but rather to accept a reduced purchase price.

3.3 Wording of the contract in *ITC 1839*

The wording of the contract is submitted as follows (at page 64):

Clause 4 of the Sale Agreement reads as follows: 'In consideration for the sale of the Business, the Purchaser will pay the purchase price…' The 'Business' was defined in clause 2.2.3 of the Sale Agreement as 'the retail clothing business conducted by the Seller under the style of 'XXX', which includes the Business Assets of the Seller, the Liabilities and the Contracts of the Effective Date'. The 'Purchase Price' was defined in clause 2.2.21 of the Sale Agreement as 'the amount equal to the sum of R800 000 000 (eight hundred million rand) and the rand amount of the Liabilities'. 'Liabilities' were defined in clause 2.2.16 of the Sale Agreement to mean 'all of the liabilities arising in connection with the Business, in respect of any period prior to the Effective Date, known to the Seller as at the Effective Date'.

The appellant alleges that, upon the sale of its business, it made certain accounting provisions and that the relevant amount is the aggregate of the following accounting provisions made by it – Bonus: long term R6 394 111; Full repairing lease R900 000 and Medical expenses R11 698 880 (reduced to approximately R9 800 000). Totalling approximately R17 million.

The liabilities in the above paragraph formed part of the total liabilities in the sum of R329 440 402.

In terms of clause 6.1 of the Sale Agreement the parties agreed the following:

> The Purchase Price shall be discharged as follows by the Purchaser:
>
> 6.1.1. as consideration for the Inter Company Loans and Other Loans, the Purchaser will assume an equivalent amount of the Accounts Payable;
>
> and
>
> 6.1.2 as consideration for the remaining Business Assets:
>
> 6.1.3.1 the Purchaser will assume the remainder of the Liabilities, and
>
> 6.1.2.2 the Purchaser will with effect from (*sic*) the Effective Date owe the Seller R800 000 000,00 (eight hundred million rand) as a loan and which will be reflected as a loan account in the books of the Seller.

The above is therefore the manner of discharge of the purchase price. In terms of clause 5.1 of the Sale Agreement, the parties agreed that 'the Purchase Price (would be) allocated as follows to the Business Assets':

5.1.1 Immovable Property, the net book value as reflected in the Effective Date Management Accounts'.

5.1.2 Plant, machinery, equipment, vehicles, trade debtors, inter company loans, other loans and inventory, the net book value as reflected in the Effective Date Management Accounts.

5.1.3 Trade Debtors, 'the net book value as reflected in the Effective Date Management Accounts'.

5.1.4 Inter Company Loans, 'the net book value as reflected in the Effective Date Management Accounts'.

5.1.5 Other loans, 'the net book value as reflected in the Effective Date Management Accounts'.

5.1.6 Inventory, 'the net book value as reflected in the Effective Date Management Accounts'.

5.1.7 Cash and cash equivalents, 'the face value as reflected in the Effective Date Management Accounts'.

5.1.8 Trademarks, 'the market value determined by the Seller as at the Effective Date'.

5.1.9 Goodwill, 'the balance'.

The 'Effective Date Management Accounts' were defined in clause 2.2.8 of the Sale Agreement to mean:

> the management accounts reflecting the financial affairs of the Business on the day immediately preceding the Effective Date, which shall be attached as Annexure 'A' hereto as soon as possible after the Effective Date.

Annexure 'A' of the Sale Agreement is headed 'Analysis of purchase price' and allocates and amount of R800 million. The amount of R800 million is the difference between the aggregate of the positive amounts reflected in Annexure 'A' (R1 111 692 717) and the aggregate of the negative amounts reflected in Annexure 'A' (R311 692 717).

In terms of clause 10 of the Sale Agreement, the parties agreed to 'comply with their respective obligations in relation to the employees, as set out in Annexure 'E'.

In terms of paragraph 1.2 of Annexure 'E', the parties agreed that the purchaser, C, would be substituted in place of the seller in respect of all employment contracts in existence immediately before the effective date. Paragraph 2.1 of Annexure 'E' reads as follows:

> The Seller shall bear the cost of salaries, PAYE income tax, employer UIF, pension and medical aid contribution, leave pay and other benefits in respect of the Employees accrued in respect of any period up to and including the Effective Date.

Paragraph 2.2 of Annexure 'E' reads as follows:

> The Purchaser shall bear the costs of salary, PAYE income tax, employer UIF, pension and medical aid contributions and other benefits in respect of the Employees in respect of the period after the Effective Date.

Paragraph 2.3 of Annexure 'E' reads as follows:

> For the purposes of section 197(7)(4) of the Labour Relations Act No 66 of 1995, as amended ('LRA'), the Parties will agree on or before the Effective Date, the valuation up (*sic*) and including the Effective Date of:

> 2.3.1 accrued salary, PAYE income tax, employer UIF, pension and medical aid contributions in respect of Employees;
>
> 2.3.2 leave pay accrued to the Employees;
>
> 2.3.3 severance pay that would have been payable to the Employees in the event of a dismissal by reason of the Seller's operational requirements; and
>
> 2.3.4 any other payments that have accrued to Employees but have not been paid…

Clause 10 read with Annexure 'E' provided for a complete assumption of responsibility by the purchaser in respect of amounts owing to employees in accordance with section 197 of the LRA.

The appellant has not been able to locate any valuation as contemplated in paragraph 2.3 of Annexure 'E'.

Paragraph 2.5 of Annexure 'E' reads as follows:

> On the Effective date the Seller shall pay the Purchaser the sum of the calculation referred to in 2.2 above in respect of accrued salary, leave pay, PAYE income tax, employer UIF, pension and medical aid contributions in respect of the Employees in respect of the period up to and including the Effective Date, which amounts have not otherwise been paid in respect of the Employees…'

No payment was made by the appellant in cash in respect of the liability in paragraph 2.2 of Annexure 'E' but C, as the purchaser, assumed all liabilities in respect of employees.

3.4 Appellant – introduction

In *ITC 1839* the taxpayer contented that it was entitled to the deduction in terms of section 11*(a)* read with section 23*(g)* of the Act. It also argued that, on a proper construction of the agreement of sale, it had foregone the portion of the purchase price representing the liabilities in consideration for the purchaser assuming those liabilities and therefore this portion of the purchase price represented 'expenditure actually…incurred' within the meaning of section 11*(a)* of the Act.

It argued further that expenditure incurred by the taxpayer to rid itself of anticipated or contingent revenue expenses were generally itself of a revenue nature. The taxpayer contented that that the conclusion of the sale agreement with the purchaser gave rise to incurred expenditure towards the sale agreement with the purchaser in an amount equal to the contingent liabilities in issue and it was this expenditure that the taxpayer sought to deduct and, accordingly, the expenditure had actually incurred within the meaning of section 11*(a)* of the Act, i.e. there had been a diminution of the taxpayer's patrimony the same as a loss and thus the relevant amount was deductible (at page 61).

The court accepted that had the taxpayer retained its business and continued to trade, the amounts would be deductible when they became unconditional. The court further was dismissive of the argument that expenditure, like losses, do not necessarily arise from a legal obligation owed by the taxpayer to a third party. The taxpayer's argument was that expenditure is wide enough to encompass all actual quantifiable diminutions or prejudicial effects suffered by the taxpayer's patrimony – instead of strictly legal concept expenditure and losses is an economic or commercial concept. However the court was of the opinion that even if it is to be accepted that the economic consequences of a transaction is to be examined rather than 'strict law or obligations', there were in fact an increase in the taxpayer's patrimony – the economic consequence according to the court was the taxpayer was relieved of the risks that the contingent liabilities would materialise and received R800 million risk free in return.

The court also did not favour the argument that the assets and liabilities of the taxpayer did not lose their individual identities as a result of the disposal of the business as the sale of the business itself in strict law consists of the sale of individual assets and the assignment of liabilities which resulted in the set off of the assets and liabilities and the net purchase price of R800 million, as the taxpayer had already made the argument in respect of expenditure incurred that the economic consequences of the transaction should be examined, rather than a strict legal incurral of an obligation; according to the court this was to 'have one's cake and eat it at the same time'. The court was of the opinion that one must have a holistic, economic and commercial view of the transaction, and that that there was no diminution in the taxpayer's patrimony, but actually the converse (at page 63).

The taxpayer had further attempted to identify the nature of the expenditure by extrapolating principles from English case law that support the conclusion that lump sum payments or expenditure do not necessarily alter the fact that the 'expenditure' in question could not be indentified as being 'incurred' in the production of income and for the purposes of trade. However the court found that this was irrelevant as it was of the opinion that it was never misled by the lump sum characteristics of the payments (at page 71).

The three underlying contingent liabilities are R9.8 million in respect of post-retirement medical aid liability; R6.3 million in respect of long-term bonuses and R0.9 million in respect of full repairing leases, amounting to approximately R17 million.

The heads of argument, as per this tax court judgement, will be looked at in some more detail in the following paragraphs.

3.5 Arguments in favour of the appellant

From the aforementioned paragraphs it is already clear that several tax consequences arise during the sale of a business and carefully consideration is therefore needed.

ITC 1839 adds the following questions to the already, not easily deciphered, set of rules:

did the conclusion of the sale agreement with the purchaser give rise to incurred expenditure?; did the seller forego (i.e. was there a set-off?) a portion of the purchase price?; is expenditure incurred by the taxpayer to rid itself of anticipated or contingent revenue expenses generally of a revenue nature?; and was there a step-down of the taxpayer's patrimony the same as a loss and thus the relevant amount was deductible? The preceding questions (and other) will be discussed in more detail with reference to the *ITC 1839* case and other relevant literatures.

3.5.1 Actually incurred

Court cases discussed (also refer to *2.2*) will be referred to and other relevant court cases will also be briefly discussed in this section.

What can be derived from the *Port Elizabeth Tramway* and *Caltex Oil* case is that 'actually incurred' qualifies the expenditure to be due and payable. However, even when expenditure is incurred within a particular assessment year, the payment can be made in a subsequent year.

As stated in *Port Elizabeth Electric Tramway* case, 'expenditure involves losses of floating capital employed in the trade which produces the income'. On that basis, whether the loss or outgoing is voluntary or involuntary is of no consequence.

The word 'incurred' does not merely mean 'paid'. As long as the liability to pay an expense has been incurred, it is deductible. Therefore a trader may at the end of the year of assessment owe money for stocks bought by him or for services rendered to him during the course of the year. He has not 'paid' anything on account of those liabilities, but they have been 'incurred' and are deductible. Actual payment is therefore not essential for the deduction of expenditure; the Act merely requires that it must have been 'incurred' (De Koker, 2010: ¶ 7.5).

It has been held that the word 'incurred' means either 'paid' or 'becoming liable for'[16].

As for the word 'actually', it has been held that it does not add anything to the 'plain and ordinary meaning' of the word incurred[17].

But in the *Golden Dumps* case[18] this approach was criticized, on the basis that to regard the word 'actually' as being superfluous and to ignore it would be contrary to the principle of statutory construction that a meaning should be given to every word. The word could not have been used by the legislature through inadvertence or error. Its dictionary meaning is 'in act or fact; really'. And an unreported Australian decision suggests that it means 'ascertained', 'encountered', 'run into', 'fallen upon' and not merely 'impending, threatened, or expected'. In other words, or so it would appear from the line of the court's reasoning, the liability under consideration must not be contingent (De Koker 2010: ¶ 7.5).

However, section 11(*a*) applies the complex phrase 'expenditure and losses'. A 'loss' may be suffered without being the cause of an obligation owed by the taxpayer to a third party, e.g. where a trader's stock is stolen by employees. A liability or obligation will usually not need to be represented by the amount of a liability owed by the taxpayer to a third party.

[16] ITC 542 (1942) 13 SATC 116 at 118
[17] ITC 1117 (1968) 30 SATC 130 at 131
[18] 1993 (4) SA 110 (A), 55 SATC 198 at 204–5

3.5.2 Set-off

Christie (2001:552) states that set-off may be regarded as a form of payment, and even as the equivalent of payment in cash. A party is excused from performing if the other party owes him a debt that admits of set-off against the first party's debt. For set-off to operate the following requirements must be satisfied:

- The parties must be indebted to each other and each of them must owe and be owed in the same capacity. So, for example, set-off does not operate if A owes B and B owes C, or if A owes B in B's representative capacity (eg, as trustee, liquidator, or guardian) and B owes A in A's personal capacity.
- The debts must be of the same kind. A money debt, for example, cannot be set off against a claim for delivery of property.
- The debts must be due and enforceable. Set-off does not operate if, for instance, one of the debts is subject to a suspensive condition or is only enforceable at a future date.

  > In *Asco Carbon Dioxide Ltd v Lahner* 2005 (3) SA 123 (N), A owed L a debt in respect of a cost order and L was indebted to A in terms of suretyship undertaking. The court held that, as L's suretyship debt would become due and enforceable only once excussion of the principal debtor had taken place (which had not occurred), the two debts were not extinguished by set-off. A, accordingly, could not prevent L from executing on the costs order.

- The debts must be liquidated, i.e., fixed by agreement or by law or for amounts which are capable of being easily and promptly proved. So, a claim for damages (being generally unliquidated) is ordinarily not susceptible of set-off.

Given the above requirements, set-off operates automatically: it does not have to be raised or invoked by one of the parties. If the debts are for the same amount, set-off extinguishes both of them. If the debts are for different sums, the greater is reduced by the amount of the smaller which is extinguished (Sharrock, 2007:525).

The principle that set-off operates automatically was settled by Innes CJ, giving the judgement of the Appellate Division (now called Supreme Court of Appeal) in *Schierhout v Union Government:*

> The doctrine of set-off with us is not derived from statute and regulated by rule of court, as in England. It is a recognised principle of our common law. When two parties are mutually indebted to each other, both debts being liquidated and fully due, then the doctrine of compensation come into operation. The one debt extinguished the other *pro tanto* as effectually as if payment had been made. Should one of the creditors seek thereafter to enforce his claim, the defendant would have to set up the defence of compensation by bringing the facts to notice of the Court – as indeed the defence of payment would also have to be pleaded and proved. But, compensation once established, the claim would be regarded as extinguished from the moment the mutual debts were in existence together.

(Christie, 2001:553)

3.5.3 The patrimony concern

The learn judge suggested that because the sale was for the net amount and that the provision concerned was contingent, it could not be said that an expense had been actually incurred – there was, said the judge, no reduction of the seller's patrimony (wealth) when he was relieved of an uncertain future liability. With respect, it seems that the correct view should have been that because the cost to the purchaser of taking over the provisions had been set off against the amount owing for the assets (which the judge accepted for purposes of argument), an expense (or possible loss) had indeed been incurred. 'Patrimony' has nothing to do with the issue (Clegg, 2010a:19).

3.5.4 Nature of the expense

After dealing with the above, it is now necessary to turn to the deductibility of the expense. In order for the expenditure to be deductible in terms of section 11(*a*), it must have been incurred 'in the production of income' and not be 'of a capital nature'. Also, deductibility must not be prohibited by any of the provisions of section 23.

Section 23*(e)*, 23*(f)* and 23*(g)* of the Act were called forth by the respondent. As noted by the judge, the matter does not involve the carrying of income to a reserve fund or capitalisation of income. Thus, section 23*(e)*, which prohibits a deduction in respect of 'income carried to any reserve fund or capitalised in any way', is not relevant.

Section 23(*g*) is a general prohibition section which provides negatively for what may not be deducted. The deduction claim must therefore satisfy section 11*(a)* and section 23*(g)*.

The taxpayer had given up the portion of the purchase price representing the liabilities in consideration for the purchaser assuming those liabilities and therefore this portion of the purchase price represented 'expenditure…incurred' within the meaning of section 11(*a*) of the Act. Further it was also submitted by the appellant that expenditure incurred by the taxpayer to rid itself of the anticipated or contingent revenue expense was generally itself of a revenue nature (at page 62).

Following the above, the next step should be to establish the nature of expenditure incurred by a taxpayer to rid himself from liabilities already undertook but still contingent. It is submitted (as gathered from the case on page 70) that there is relatively little South African authority directly in point and that it could be useful (and necessary) to review English and Australian authority. Note that the judge submitted (at page 71) that:

> These (English and Australian) cases are interesting but, for reasons which, we trust, will become clear a little further on, quite unhelpful for the appellant. They all dealt with 'lump sum' deductions. Whether payments are for a 'lump sum' or even, as was artfully argued, 'compressed expenditure' does not alter or even answer the questions that have necessarily been posed in this case such as whether or not the relevant amount constitutes 'expenditure'; whether it was actually incurred; whether it was incurred in the production of income; whether it was of a capital nature; whether it was incurred for the purposes of trade; and whether or not it was capitalised in any way. The court accepts, however, the thrust of Mr Rogers's argument that while 'lump sum' payments may generally, at first blush, have a 'forbidden' character when it comes to tax-deductibility, this is not necessarily the case. It will, no doubt, be the appellant's lament that this well-prepared argument does not assist it in this case. It should be added that, at no stage was the court, in the slightest way beguiled, led astray, disturbed or perturbed by the 'lump sum' character of the relevant amount.

Selected English and Australian authority, mentioned by the judge in *ITC 1839* (at page 70), will be discussed to prove that the abovementioned extract is, with respect, not entirely accurate.

English case law

In the *Smith v Incorporated Council of Law Reporting for England and Wales*[19] case a lump sum gratuity paid to a retiring employee was held to be deductible. The lump sum payment was not in exchange of an existing pension liability but a gratuitous recognition for past service (though in accordance with the expectation of employees).

The case of *Hancock v General Reversionary & Investment Co Ltd*[20] a certain employee had retired in 1905. In accordance with the employer's usual practice he was awarded an annual pension. In 1913 the pension was exchanged by the purchase by the employer of an annuity for the retiree for a lump sum.

Lush J held that the lump sum expenditure was not of a capital nature and was thus deductible. He referred to the once-for-all test and said:

> [A]pplying that test I think that it necessarily follows, on the facts found by the Commissioners, that the [lump sum] should be treated, as the pension was treated, as an ordinary business expense and that the deduction should be allowed. It is the pension in another form; it is actuarially equivalent in value and it is identical in character. It was paid to meet a continuing demand which was itself an ordinary business expense as the surveyor has treated it... It seems to me as impossible to hold that the fact that a lump sum was paid instead of a recurring series of annual payments alters the character of the expenditure as it would be to hold that, if an employer made a voluntary arrangement with his servant to pay the servant a year's salary in advance instead of paying each year's salary as it fell due, he would be making a capital outlay.

Accordingly, in the *Hancock* case, the liability which the employer was relieved from by a lump sum was contingent (i.e. the employee's life expectancy). It should be noted that the future liability (or contingent liability) was held not to be of a capital nature and therefore deductible.

[19] 1914 3 KB 675

[20] 1919 1 KB 25

A further case mentioned was *Rowntree & Co Ltd v Curtis*[21]:
In the *Rowntree* case the company in the ordinary course provided relief to employees in circumstances of illness and hardship. The company, after an exceptional flourishing year, decided to form a trust and allocated a lump sum to the trustees, on the basis that the trust income would be used to pay these expenses by way of payments to employees in agony.

The court held on appeal that the lump sum settlement was not deductible. Pollock MR said that he had found the case a difficult one. Although on the facts the payments to suffering employees were a continuous demand on the company's business, he held that the lump sum was a capital expense. In distinguishing *Hancock's* case he emphasised that no actuarial calculation of the future demand was possible or had been undertaken. There was no way of saying whether the lump sum would meet the demand or be needed in full. It was thus 'impossible to say that this was invalidity insurance in another form' (at page 339).

Pollock MR also counterpointed the *Rowntree* case with another case 'in which expenditure is made on business grounds of a sum, apparently a capital sum, but which really comprises and compresses what is an annual charge'. He submitted, in general (at page 336):

> Where you find that there is a continuous business demand, you may, on business principles, commute that continuous demand and on prudent grounds make a payment which covers more than the particular year, and you may be able to show that that sum has been spent in order to obviate the continuous business demand and, hence, that it is a sum wholly and exclusively laid out in the earning of the profits.

Warrington J agreed with the Pollock MR's reasoning (at page 343):

> The expenditure which has been made is not expenditure of money merely for the purpose of meeting the demand in the particular year – that is quite plain – but it is intended to meet the expenditure for an indefinite number of years, and expenditure of an indefinite and incalculable amount. There are no actuarial principles by which the amount could be ascertained or computed. It is absolutely uncertain what amount the company will have to meet.

[21] 1925 1 KB 328 CA

This *Rowntree* case is quite clearly distinguishable from the *ITC 1839* set of facts. The statement that 'No actuarial calculation of the future demand was possible or had been undertaken*'* is not applicable to *ITC 1839*. An amount has been calculated (relating to all three contingencies) and the services were already rendered (relating to the bonus and post employment benefits contingency) during the normal course of business

The next case selected from the list mentioned in *ITC 1839* is *British Insulated & Helsby Cables Ltd v Atherton*[22]:

A company formed a pension fund for its employees by way of a trust. It allocated a lump sum as the basis of the fund to finance the past service benefits of current employees. Future service benefits were to be met by recurring contributions from employees and also from the company. The issue at hand was if the current contributions by the company were deductible.

At first the judge submitted that contributions were deductible and this submission was overturned by three judges in the Court of Appeal. On further appeal to the House of Lords it was held by a majority (three against two) that the lump sum was of a capital nature and not deductible.

Viscount Cave submitted that 'when expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such expenditure as properly attributable not to revenue but to capital' (at page 213). Viscount Cave, in his concluding comments on the nature of the lump sum payment, submitted (at page 214):

> [I]t is a fair inference from the terms of the deed and from the Commissioners' findings that without this contribution the fund might not have come into existence at all. The object and effect of the payment of this large sum was to enable the company to establish the pension fund and to offer to all its existing and future employees a sure provision for their old age, and so to obtain for the company the substantial and lasting advantage of being in a position throughout its business life to secure and retain the services of a contented and efficient staff. I am satisfied on full consideration that the payment was in the nature of capital expenditure...

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[22] 1926 AC 205 HL

Lord Carson stated, in his dissenting judgement (at page 225):

> It is clear from the terms of the trust deed, as already pointed out, that in no sense was the sum an investment, that it would be eventually exhausted in payment of the pensions, and that in the event of a winding-up of the company it could never form any part of the assets of the company. I cannot, under these circumstances, conceive any system of commercial accountancy under which this sum could ever appear in the capital accounts of the company. Nor is it capital withdrawn from the business, as it was admittedly paid out of the earnings of the year. It is not disputed that an annual sum contributed to the pension fund on an actuarial basis for the purposes of making the fund solvent for paying the pensions of the older members of the staff would be a proper deduction in arriving at the balance of profits and gains, it would be an ordinary business expense...Why, therefore, should the payment of the sum in question, which by an actuarial calculation represents the sum equal to the annual payments which would be necessary, not be considered as in the same position?

Lord Blanesburgh in his dissent submitted that (at page 229):

> [The lump sum] was a payment by the company on account of each of these employees of a sum which... comprised and compressed a series of prior annual payments on his account. It was a sum, and this is perhaps in the present connection its most important characteristic, actuarially so adjusted in amount that when the last of the existing staff, participant to the fund, on whose account it had been paid died or fell out of benefit no part of it or of any accretion to it would remain in the hands of the trustees. It would then have been entirely exhausted in providing the covenanted benefits for the participants on whose account it was paid.

With reference to the above it is clear that Viscount Cave and Lord Buckmaster thought the *Hancock* case was correct but distinguishable (at pages 213 and 224). Lord Atkinson did not agree with *Hancock's* case (at pages 222-223) still; both dissenting judges were of the opinion that *Hancock's* case was not only correct but applicable to the facts of the case (at pages 225-226 and 232-233).

Anglo-Persian Oil Co Ltd v Dale[23] was a case where a company, which was required under a long term contract to pay an agent annual amounts, negotiated the early termination of the contract by paying the agent a lump sum. The full bench held that the lump sum payment was deductible. It was submitted that the expenditure had not brought into existence any permanent fund – distinguishable from the *Atherton* case.

[23] 1932 1 KB 124 CA

The company had merely paid the lump sum in order to conduct its business in what it thought would be a more efficient manner (at page 142). If a contract was onerous simply because it entailed a heavy drain on the company's annual revenue, the company did not secure an enduring benefit by getting rid of the contract (at page 147).

In *Heather v P-E Consulting Group Ltd*[24], a company which had formed a share trust for employees were required to pay 10% of its profits to the trust each year. Once more the question was whether these annual payments were deductible:

Lord Denning submitted: 'Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange' (12f). Lord Denning said that the annual payments were more similar to the recurrent payments in the *Atherton* case than the lump sum payment which had been disallowed in the *Atherton* case.

Buckley LJ said that he did not find it easy to put his finger on any passage in the majority judgments in the *Atherton* case which clearly stated what the difference was (at 15d). He suggested the following possible distinction (at 15g-h):

> The establishment of such a fund was a condition precedent to the establishment of the contributory scheme. In order to open the way to the establishment of the scheme, the company itself provided the fund. That is what is called the nucleus fund. As expenditure distinct from the company's subsequent contributions, it was a once-for-all expenditure, which made it possible for the company to embark on a scheme which would benefit its commercial activity. It might perhaps in fanciful language be said to have prepared the ground or provided the site on which the scheme itself should be erected. Seen in this light, the initial payment can perhaps justifiably be viewed as having a different character and being made with a different object from the company's subsequent annual contributions.

In *Vodafone Cellular Ltd v G. Shaw (HM's Inspector of Taxes)*[25] the English Court of Appeal had to mull over a case where the taxpayer had paid $30 million to another party (Millicom) in order to relieve itself of a onerous 15-year agreement in terms whereof the taxpayer had to make annual fee payments to Millicom for licence rights and know-how:

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[24] 1973 All ER 8 CA

[25] 1997 EWCA Civ 1297

It was held that the expenditure was made for purposes of trade and was not of a capital nature.

Millett LJ submitted the following:

> Two matters are of particular importance: the nature of the payment; and the nature of the advantage obtained by the payment. The fact that the payment is a lump sum payment is relevant but not determinative. In a case such as the present, where the payment is made in order to get rid of a liability, a useful starting point is to inquire into the nature of the liability which is brought to an end by the payment. Where a lump sum payment is made in order to commute or extinguish a contractual obligation to make recurring revenue payments then the payment is prima facie a revenue payment.

Thus, comparable to the other cases, the liability was contingent (depending on a future result) with regards to the sums payable (the fee to Millicom was profit-based).

Australian case law

In *Spotlight Stores Pty Ltd v CoT*[26] the employer had settled $15 million on trustees as a fund out of which future annual bonuses were to be paid to employees. Although the employer had a long-standing practice of paying annual bonuses, the trust was established as part of a revised bonus scheme. The initial contribution of $15 million was an estimate of the bonuses that would become payable under the new scheme over the first five years. The trust deed stated that the employer would continue to make contributions annually. The benefits achieved by the establishment of the new scheme were improved staff retention, morale, productivity and loyalty.

The court held that the payment was not of a capital nature and was thus deductible. Although it was found that the payment was deductible, the court decided that the payment was part of a tax avoidance scheme – not relevant with regards to the facts of *ITC* 1839.

It was stated by the court that the answer to the capital/revenue question depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights (if any) secured, employed or

[26] 2004 FCA 650

exhausted in the process. With regards to the latter principles the court concluded that by the $15 million contribution was of a revenue nature. It was effectively a prepayment of bonuses expected to become payable over the next five years, which was the period over which the advantage of enhanced profitability in consequence of improved staff morale and loyalty was expected to be enjoyed (at paragraphs 53-55).

The court quoted the *Hancock* case in support of the conclusion that the prepayment of future bonuses in a lump sum did not result in the contribution being on capital account. The court distinguished the *Atherton* case by saying that whereas the lump sum contribution in that case had been to provide the nucleus of a fund expected to endure for the life of the company, the contribution in the *Spotlight* case was to enable bonuses to be paid over the ensuing five years and would be progressively diminished over that period. The lump sum was in substitution of the annual contributions Spotlight would otherwise have had to make. The trust had to be 'refilled' by further contributions no and again. The contribution was made to meet a continuous demand which the company had to meet out of the returns of trade and 'was enduring only to the extent that for a good number of years it were expected to relieve Spotlight of a revenue payment' (at paragraph 71).

The *Spotlight* case was taken on appeal, and is reported as *Pridecraft Pty Ltd v CoT; CoT v Spotlight Stores Pty Ltd*[27]. The Full Court upheld the lower court's decision, including specifically the decision on the capital/revenue question (at paragraphs 95-100). The Full Court noted, with reference to the decision of the House of Lords in the *Atherton* case, that the House had been divided on the outcome. The Full Court observed that it was perhaps debatable whether it was appropriate for the majority in the *Atherton* case to have characterised the advantage obtained from the contribution to the pension fund as enduring for the benefit of trade.

In a South African case, *SIR v John Cullum Construction Co (Pty) Ltd*[28] the court emphasised that the payment was not made to acquire, enhance or preserve a capital asset (at 714f).

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[27] 2004 FCAFC 339

[28] 1965 (4) SA 697 (A)

In *ITC* 1839, as noted, the contingent liabilities (post employment benefits, bonus/leave payments and repairs and maintenance of capital assets) which the taxpayer was relieved from were revenue expenses. Consequently, if one follows the general principle in all the abovementioned cases, it can be cogently argued that the expenditure incurred by the taxpayer to relieve itself from the contingent liabilities was itself of a revenue nature.

Also, in the *ITC 1839* case no asset was brought into existence in consequence of the expenditure. It has been submitted in various cases, e.g. in *George Forest Timber Co Ltd*[29], *CoT v Nchanga Consolidated Copper Mines Ltd*[30], *ITC* 1241[31] and *ITC* 1267[32] that expenditure not made in order to create an income-producing concern or to establish or enhance an income-earning structure is not capital in nature and therefore deductible.

Hence, with respect, the principle in the above cases was not only primarily to prove that the lump sum has a 'forbidden' character. The focus is clearly on the capital and revenue nature distinction. It is therefore submitted that the same principle can be applied in concluding that the expenditure that the taxpayer 'incurred' in *ITC 1839* was in the production of income and for purposes of trade.

It is noted that the liabilities, although contingent as at 1 March 2004, were raised during the seller's normal course of business. If a taxpayer sells his business, excluding his liabilities, he will receive a higher price for the business. The additional amount received would then be used to meet the liabilities when they become unconditional. But, when the time comes, the taxpayer will no longer be trading and the expenditure will therefore not be incurred in the production of income. Although he has ceased trading activities, it is not logical to argue that the liabilities, raised during his normal course of business while he was trading, would not be deductable even though he ceased to trade.

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[29] 1924 AD 516 at 526-527

[30] 1964 (2) SA 472 (PC) at 476A-477D

[31] 1975 (37) SATC 300 at 306

[32] 1977 (39) SATC 146 at 151

As learned from *ITC 1029*[33], the courts has demonstrated that in assessing whether the requirements of section 11(*a*) and section 23(*g*) are met, one must look to the taxpayer's purpose at the time he undertook the commitment:

> if expenditure is deductible by a taxpayer while he carries on business, the fact that he ceases to carry on that business does not render such expenditure non-deductible provided that it arises out of the taxpayer's activities prior to the cessation of his business operations.

The above case was taken on appeal, and is reported as *CoT v Cathcart*[34]. It did not seem that the court oppose the judgement that a deduction could be made in respect of a contingent liability which realised after the taxpayer had ceased trading. The appeal succeeded on the grounds that the taxpayer failed to prove that he had in fact been under an obligation to pay.

It is also submitted that (at 510D-F):

> It does not seem to me, therefore, that it is a correct approach to look solely to the period when the event which gives rise to the expenditure occurs in order to determine whether it is expenditure solely and exclusively made in the production of income or for the purposes of trade. If the risk of incurring the particular type of expenditure in question is deliberately undertaken by contract in order to earn the income, then, when that risk is fulfilled and the expenditure is in fact incurred, it is so closely connected with the performance of the business operation that it would be proper, natural or reasonable to regard it as part of the cost of performing the operation. It seems to me that such expenditure is properly deductible in terms of sec. 13(2)(a).

ITC 729[35] is another case dealing with a business that ceases trading. In this case three individuals had conducted trade in partnership. During the time that the business was carried on the partners undertook to pay periodic pensions to certain retired employees. Upon the sale of the partnership's business, the obligation to pay the pensions was not taken over by the purchaser. In a year subsequent to the year of the sale, one of the partners claimed a tax deduction for pension payments made to former employees. The Commissioner refused the deduction on the basis that the partnership had ceased trading

[33] (1963) 26 SATC 54 at 58

[34] (1965 (1) SA 507 (SRAD)

[35] (1951) 18 SATC 96

and that the expense was thus not incurred wholly and exclusively for purposes of trade (in accordance with the requirement then set in section 12(*g*) of Act 31 of 1941).

It was submitted that (at page 96):

> I think the argument overlooks that fact that section 12(g) does not only refer to monies expended but also monies laid out. When originally the obligation was undertaken to pay the pensions it was undertaken for the purpose of trade. An employer, as part of the wages to an employee, gives him an undertaking that when he retires he will be paid a pension. That undertaking amounts to a laying out of monies for the purpose of trade. Nor does paragraph (g) state that the monies must be laid out or expended for the purpose of trade during the year for which the assessment is being made. The paragraph is in wide terms and only requires that the payment must be one which was for the purposes of trade, so that once it is established that the obligation to make the payment was for the purpose of trade, then when that obligation is discharged it remains a payment for the purposes of trade.

In *ITC1627*[36] was a case dealing with ongoing interest payments incurred by a taxpayer after the venture for which the money had been borrowed had failed. In that case the taxpayer had entered remunerated employment, succeeding to his venture failing, and the interest was held to be deductible against the income derived from his employment. The Court also said that there was much to be said for the view that trading only ceases when all debts of the business have been paid and quoted English authority.

Lastly, in *Tornado Transport (Edms) Bpk v KBI*[37] a payment was made by the taxpayer to a surety who had paid on behalf of the principal debtor and had exercised his right of recourse against the taxpayer. The Court held (at page 378 - 379) that when an assessment is made of closeness of connection between the expense (the payment to the surety) and the cost of performing the taxpayer's transport business, the surety payment took on the characteristics of the underlying expense (the payments for fuel) that gave rise to the payment made by the surety on behalf of the taxpayer. With regards to the timing of the expense, the court held that it was during the year that the payment was made to the surety, and not in another period as contented by the Commissioner, during which the underlying expense was incurred.

[36] (1997) 60 SATC 26

[37] 62 SATC 373

3.5.5 Conclusion

It seems that from the 'actually incurred' discussion the actual payment is not essential for the deduction of expenditure; the Act merely requires that it must have been 'incurred'.

The next question therefore is whether an expense has indeed been incurred. It is submitted that set-off may be regarded as a form of payment and even as the equivalent of payment in cash. It is also not required for the agreement to provide for sett-off for the amounts reciprocally owed.

The terms of the agreement and the method for the discharge (set-off) of the purchase price thus gave rise to expenditure in the hands of the appellant in the amount of the liabilities.

The seller's obligation to pay to the purchaser the amount of the contingent liabilities became unconditional on 1 March 2004, and it actually paid the amount on 1 March 2004 by way of set-off against the purchase price owed to it by the purchaser. As gathered from principles in various judgements, the potential cessation of the taxpayer's trade after 1 March 2004 does not play an influence.

Further, the expense did not establish an 'income-producing machine', it did not result in the acquisition of an income producing machine and it did not add to any existing income-producing machine. It is a recurring expense which forms part of the cost of performing income-earning operations and is not part of the cost of acquiring an income-producing concern. It could also be said that a payment to the purchaser (i.e. the set-off) may be compared with paying an insurance premium to a third party.

3.6 Respondent - introduction

The respondent disallowed the expenditure on the grounds that they did not constitute expenditure; they do not constitute expenditure actually incurred; they did not constitute expenditure incurred in the production of income; if they were expenditures, they were of a capital nature; if they were expenditures, they were not incurred for the purposes of trade; and they were in any event prohibited from a deduction in terms of section 23*(e)*, 23*(f)* and 23*(g)*.

3.7 Arguments in favour of the respondent

This chapter, in a concise manner, sets out to identify the contentions that the respondent applied in its head of arguments. The most important principles which have arisen during the course of the *ITC 1839* case will be discussed below.

3.7.1 Did not constitute expenditure nor actually incurred

It has been submitted that the underlying expenditure relating to the relevant amount was part of the liabilities reflected in the accounting records of the appellant. The liabilities constituting the relevant amount in issue had not come into existence on 1 March 2004 and they were conditional and it was clear that until such liabilities became unconditional they did not constitute 'incurred expenditure'. It was submitted that the expenditure on the relevant amount could only have been incurred if one accepts construction of events that the appellant 'paid' the respondent R311 692 717 in order to be relieved of its (the appellant's) liabilities (at page 71).

In other words, because the sale was for the net amount and the provision concerned was contingent, it could not be said that an expense had been actually incurred. The judge was also of the opinion that there was no reduction of the seller's patrimony (wealth) when he was relieved of the uncertain future liability (refer *3.5.3* for a further discussion).

The court did not dwell on this aspect since it was of the view that the appellant faces more essential difficulties (at page 72).

3.7.2 Not expenditure in the production of income

It was stated in the *ITC 1839* case that this question is closely related to the above mentioned discussion. It only arises if one accepts that the appellant 'paid' the amount in order to be relieved of its liabilities. In other words, to generate income not of R800 million but of some R1.1 billion. The judge also said that if one reads the definition of 'income' together with that of 'gross income' in the Act, it is clear that 'income' excludes 'receipts or accruals of capital nature' (at page 72).

Further it was submitted that the 'expenditure incurred' was not in the production of 'income' from the disposal but in the production of income previously earned by the appellant during the period that it traded prior to selling the business. Accordingly, so this argument went, the 'notional agreement expenditure' compromising the amount 'paid' to the purchaser in order for the latter to assume the appellant's contingent liabilities was incurred on payment and therefore had converted uncontingent expenditure , i.e. the 'underlying expenditure' which was conceded as contingent expenditure, into uncontingent, deductible expenditure. It was argued that the difficulty with this argument was that the 'notional agreement expenditure' did not produce 'income' arising from the sale of the business. It was said that the 'payment', if there ever was a payment, was to induce the purchaser to assume the liabilities. Had the appellant not sold its business and settled its liabilities in the normal course of trading, it would be arguable that the expenditure would be incurred in the production of income. The 'notional agreement expenditure' was, however, clearly 'incurred' in order to induce the purchaser to assume the liabilities, rather than incurred in the production of income prior to the sale of the business (at page 72)

Clegg (2010a:20) proposes:
The proper enquiry is to ask why it was that the seller found himself in the position of needing to pay the purchaser to take over the contingent liability.

He said the answer to that is twofold:

- First, because he had employed certain individuals who had rendered services and earned him income in prior years and for which, subject to a contingency as to their continued loyalty for a further period, he would be obliged to pay them already determined amount.
- Secondly, as identified by the judge, that in order to sell his business as a going concern, he needed to ensure that the purchaser could take over those employees, together with their contingent rights to payment of a bonus, and would not be out of pocket in so doing.

There were thus two causative factors and the question is, which is the *causa causans*?
Is the sale of the business the dominant causative factor, relegating the prior services to a mere *sine qua non*, or were the prior services rendered by the employees the real reason the amount was paid by the seller to the purchaser.

In *CIR v Shell Southern Africa Pension Fund* the Appellate Division of the Supreme Court (now the Supreme Court of Appeal) considered the position of the dependant of a deceased employee, to whom an amount had been paid by the deceased's pension fund. The question was whether the amount has been received by the independent by virtue of the death of the employee or exercise of discretion of the fund's trustees to select the beneficiary?

In that case, the court found that the real cause of the dependant receiving the amount was the decision of the trustees and as this was not an event which triggered a 'gross income' consequence in terms of the Act, it fell outside the provisions of the law. In the case of the bonus provision payment, it seems that it can be cogently argued that the real and fundamental reason for the payment is the undertaking by the seller to their employees in terms of his contracts of employment and that the sale of the business does no more than crystallise the timing of the incurral.

This argument may well be stronger if the payment of the contingent bonuses were made not to the purchaser of the business but to the employees themselves. But absent that variation it is difficult to deny the reality that the incurral event on the facts of the case, that is the payment to the purchaser, was timed and took place, not to recompense the employees but to enable the sale of business. In my view this relegates the contracts of employment to status of *sine qua non*, of relevance only to the quantum of the payment and not the cause.

3.7.3 Expenditure of a capital nature

It was argued in *ITC 1839* that the usual test to determine the nature of expenditure, i.e. capital or revenue, is to establish whether the expenditure is more closely connected with the income earnings operations, i.e. revenue expenditure or income earning structure (capital expenditure). It was submitted that as the sale of business would, by its very nature, cause a cessation of trading, the appellant had been unable successfully to argue that the expenditure incurred in relation to the sale would be more closely connected to its income operations (at page 73).

3.7.4 Expenditure not for the purpose of trade

The judge stated (at page 73) that is has been observed that section 23(*g*) of the Act disallows deductions for moneys which were not laid out or expended for the purpose of trade. This means, *inter alia*, that the expenditure must have been incurred for the purposes of or in connection with its profit making activities (*De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue*[38]*; Burgess v Commissioner for Inland Revenue*[39]).

It was further said (at page 73) that by reason of the definition of 'income' and 'gross income' in section 1 of the Act, this must necessarily mean profit derived from the income generating activities of the taxpayer. The transaction or transactions in question were undertaken with a view to enabling the appellant to sell its business to the purchaser as a going concern and, in particular, for the purpose of bringing and end to the appellant's trading activities.

It was submitted that there can be no question that the appellant did not pay the relevant amount prior to the happening of the event which brought about the cessation of its trading activities. The expenditure, if such it was, was not laid out or expended for the purposes of appellant's trade. This question must also be answered in favour of the respondent. The court were also referred by counsel for both sides to the judgement of Labe J in the *ITC 1627* (at page 26) wherein he supported the view that trading only ceases when all debts of the business have been settled. The court was aware that Labe J's view has not escaped criticism and that a different view has been taken (see for example *ITC 490*[40]) but, in the light of the approach which the court has taken in this matter it is unnecessary to decide which the better view is (at page 73).

3.7.5 Section 23*(e)*

The instant matter does not involve the carrying of income to a reserve fund or capitalisation of income. This section will therefore not be further discussed.

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[38] 1986 (1) SA 8 (A) at 30-31, 36-37

[39] 1993 (4) SA 161 (A) at 181

[40] 12 SATC 72

3.7.6 Section 23*(f)*

Section 23(*f*) prohibits the deduction of any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section 1 of the Act. Counsel for the respondent relied strongly upon the dicta of Corbett JA, as he then was, in the *Commissioner for Inland Revenue v Nemojim (Pty) Ltd*[41]:

> Section 11(a) provides positively and in general terms in the case of a person deriving income from the carrying on of trade within the Republic, what expenditure and losses shall be allowed as deductions from income so derived in order to determine his taxable income. The subsection limits the deduction to expenditure and losses incurred in the Republic in the production of income, other than those of a capital nature…[42]
>
> Section 23 prescribes what deductions may not be made in the determination of taxable income. Subsection (f) and (g) represents, in a general sense, the negative counterpart of section 11(*a*) and, in determining whether a particular amount is deductible, it is generally appropriate to consider whether or not such deduction is permitted by section 11(a) and whether or not it is prohibited by section 23(f) and or (g)…[43]

It was submitted that the court will therefore treat section 23(*f*) of the Act as 'in a general sense, the negative counterpart' of the 'in production of income' requirement of section 11(*a*). The court referred to its conclusion with regards to 'the notional agreement expenditure' that was clearly 'incurred' in order to induce the purchaser to assume the liabilities, rather than incurred in the production of income prior to the sale of the business (at page 74).

3.7.7 Section 23*(g)*

It should noted that the court stated that the respondent originally relied upon only four grounds for disallowing the deduction of the relevant amount: (i) that it did not constitute expenditure actually incurred; (ii) it did not constitute expenditure in the production of income; (iii) it was expenditure of a capital nature and (iv) it was not incurred for the

[41] 1983 (4) SA 935 (A)

[42] At 946E, 45 SATC 241 at 254.

[43] At 946-947A, 45 SATC 241 at 255.

purposes of trade. This point is mentioned *ex abudanti cautela* purely to deal with the potential question of there being any significance in the respondent having initially disallowed the deduction on certain grounds and then 'shifting the goalposts'. Nothing turns on this point as at least one of these original four grounds of the respondent in disallowing the deduction of the relevant amount has been upheld (at page 74).

3.7.8 Conclusion

The conclusion of the court was that the deduction of the relevant amount was not allowable in terms of the Act. The judgement also reflects the unanimous opinion of all the members of the court.

The raison d'êtres could be summarised as follows:

Production of income; accepting that the expenditure was incurred, the court submitted that it was incurred in order to induce the purchaser to assume the liabilities, rather than incurred in the production of income prior to the sale of the business.

Capital nature; the sale of business would affect a cessation of trade and the appellant had been unable to successfully argue that the expenditure incurred in relation to the sale would be more closely connected to its income operations.

Purpose of trade; the transaction were undertaken to bring an end to the appellant's trading activities. The expenditure was therefore not laid out or expended for the purposes of appellant's trade.

4 OTHER RELEVANT CONTINGENCIES NOT DISCUSSED IN *ITC 1839*

The treatment of warranties, deposits/future delivery liabilities, settlement discount and incentive-rebate provision, and retrenchment costs during the sale of a business as a going concern will be briefly looked into.

4.1.1 Warranties

Assume the seller had created a reserve to meet a warranty obligation incurred on goods sold. The following paragraphs are Olivier's (2007:612-614) view on warranties:

Position of the seller

The amount transferred to the reserve fund is not deductible against the income of the seller. Not only is the amount not actually incurred as required under section 11(*a*) of the Act, but a deduction is also specifically prohibited by section 23(*e*).

However, the mere fact that claims in respect of the warranty obligation have not been submitted to the seller before the sale of the business does not necessarily mean that no deduction can be claimed. In *Edgars Stores Ltd v CIR* it was made clear that our courts distinguish between (a) cases where the existence of the liability itself is conditional and subject to some contingency, and (b) cases where the existence of the liability itself is certain but its amount is uncertain and cannot be accurately determined at tax year-end. Where the existence of the liability itself is dependent upon a future event, then the liability cannot be said to have been incurred. The fact of the liability cannot be said to have been incurred. The fact of the liability must be absolute. It must not be conditional or subject to contingency. All the events giving rise to the liability must have occurred.

In 2004 a specific section was introduced to deal with the incurrence and accrual of unquantified amounts. Section 24M will be applicable, for example, where a business is disposed of for a percentage of the profits of the business for the next ten years. In such circumstances the seller will be taxed only when the profits accrue each year and the purchaser can only claim a deduction if and when he or she pays over the profits. Prior to the introduction of the section, the nature of the payment could have been in dispute. On the one hand, the seller could attempt to argue that the proceeds remained of a capital nature, although they were determined with reference to future profits.

On the other hand, two counter-arguments would be available to SARS: first, that, as the proceeds were determined with reference to future profits, an otherwise capital amount had been converted into an amount of a revenue nature and, secondly, that the future payments constituted annuities. As such, the profits were specifically included under paragraph (a) of the gross income definition in section 1 of the Act. The result leaves no room for the taxpayer to argue that, as the amount was of a capital nature, it should have been taxed at the lower rate applicable to capital gains, and not at the higher rate applicable to amounts of a revenue nature. Although section 24M does not expressly regulate the nature of the unquantified amount, it is submitted that it does so by necessary implication. As a result, amounts received for the disposal of an asset retain their original nature, irrespective of the fact that they may have been paid in the form of an annuity.

Care should also be exercised that where a seller did claim a deduction for warranty obligations, the purchaser should not take over the obligation to meet these obligations. If this does happen, a recoupment will arise in the hands of the seller under section 8(4)(*m*) of the Act. To avoid the application of section 8(4)(*m*), the seller should not transfer to the purchaser any of the warranty obligations in respect of which he claimed a deduction under section 11(*a*) unless he specifically pays the purchaser therefore.

Where the seller did not claim a deduction of obligations that arise under a warranty, the seller should rather make a specific payment to the purchaser in return for assuming future contingent warranties than to accept a reduction in the purchase price as the possibility exists that the payment (or at least a part thereof) is deductible, whereas this is unlikely with a reduced purchase price.

Position of the purchaser

The purchaser should not accept an amount in return for assuming the warranty obligations as he will be taxed on the receipt and uncertainty exists whether he can claim a section 24C allowance.

For the purchaser it is advisable to agree to a lower purchase price in return for assuming the liabilities. When the liabilities are honoured, the purchaser will be entitled to a deduction under section 11(*a*) if he can prove that, notwithstanding the seller receiving the income from the contract, it is still expenditure incurred in the production of income.

4.1.2 Deposits/future delivery

As part of the sale of a business the purchaser sometimes takes over the seller’s liability to deliver goods for which an order has been placed and a deposit paid.

The following paragraphs are Olivier’s (2007:610-611) view on deposits/future delivery:

Position of the seller

Where the deposit has been received or accrued to the seller, it will be included in his or her gross income. However, a section 24C allowance may still be claimed against the amount for future cost of producing and delivering the goods. But under section 24C (3) the allowance will be included in gross income in the next year of assessment. In circumstances where the purchaser takes over the liability to deliver the goods ordered, the seller will no longer be able to claim a further section 24C allowance as the Commissioner will not be 'satisfied that such amount will be utilized in whole or in part [by the seller] to finance future expenditure'.

Position of the purchaser

If the purchaser, pursuant to the sale of the business, assumes the obligation to deliver goods previously ordered from the seller, without the corresponding right to the deposit (that is, a payment therefore by the seller) and the outstanding balance, he will not be entitled to claim a deduction of the expenditure incurred in fulfilling the obligation to deliver the goods, because that expenditure will not be incurred 'in the production of income' as required by section 11(*a*).

If he assumes the right to receive the balance of the purchase price as well as the obligation to deliver, he will, in principle, be entitled to a deduction under section 11(*a*). The Commissioner may argue that the expenditure is not in the production of income to the extent that it exceeds the income derived by the purchaser from the contract. If the purchaser can prove that the expenditure is so closely related to his income-earning operations, that it can be regarded as part of them, the whole of the expenditure should be deductible.

Therefore the purchaser should, to ensure a tax effective result, not assume the obligation to deliver the goods, without getting the deposit and the right to the balance of the purchase price.

4.1.3 Settlement discount and incentive-rebate provision

A settlement discount allows the buyer of goods to pay less than the invoiced amount if the buyer makes payment within a certain period of time. An incentive- rebate provision is based on the volume of goods purchased by the buyer. These terms and conditions are negotiated in advance of the purchase of goods. In terms of accounting standards, a provision may be recognised when an enterprise has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised. The settlement discount cannot be provided at year-end for goods sold within the specified period if payment has not yet been received. The seller of the goods does not have a present obligation to give this settlement discount, and the obligation will arise only when payment is actually received. When payment is received, the settlement discount may be provided for. Under section 11*(a)* of the Act, this expense is actually incurred in the production of income and not of a capital nature and therefore deductible for income tax purposes (Kroukamp 2006:26).

4.1.4 Retrenchment costs

Retrenchment costs are associated with the reorganisation, downsizing or sale of a business. Retrenchment costs that are not yet paid may be recorded as a provision when the accounting standard conditions are met. The board of directors usually makes a formal decision to reorganise, downsize, or sell the business and the employees are then informed of the decision. The employees either volunteer to resign, or a list of layoffs is set up and the employees are informed of the retrenchments. Retrenchment costs are usually recorded as a provision for accounting, although the actual payments to the employees are still outstanding. In terms of accounting provisions, an obligation arises for expenses pertinent to the sale of a business only if there is a binding sale agreement. Accounting provisions confirm further that the employer may provide for retrenchment costs if the employer has a present obligation (sales agreement), there will be an outflow of resources (actual payment), and a reliable estimate can be made of the amount (for example, the employees' retrenchment cost is calculated on years in service and formalised in the plan to sell the business). The retrenchment provision is deductible for income tax purposes if the requirements of section 11*(a)* of the Act are complied with. The retrenchment expenditure must be actually incurred, in the production of income and must not be of a capital nature. In *ITC 1716*, the question arose as to whether retrenchment payments were in the production of income and of a revenue nature. The expenditure was held by the court to be in the production of income and of a revenue nature and therefore deductible under section 11*(a)* of the Act. The last requirement for section 11*(a)* of the Act is whether the expense is actually incurred. If there is an unconditional legal obligation for the retrenchment provision, then the expense is actually incurred and the provision is deductible for income tax purposes. If a provision for retrenchment costs does not fulfil the requirements of section 11*(a)* of the Act, then the provision will not be deductible for income tax purposes (Kroukamp 2006:40).

5 THE PURCHASER'S POSITION

From the perspective of the purchaser two main questions was not addressed by the court in the *ITC 1839* case. On the one hand the question is asked if the receipt of the payment by the purchaser of the business is subject to normal tax. On the other hand it also ambiguous if the purchaser would qualify to deduct the expense, e.g. bonus, when paid to the qualifying employees.

The recent article by Clegg (2010b:71-72) neatly sets out the possible position of these unanswered questions in *ITC 1839* as follows:

Accrual considerations

There is no reason why the treatment of expenditure in the hands of one party, should have a bearing on the treatment of the accrual in the hands of the counterparty. But the purpose for which the amount accrued is intended to be employed may be very relevant in considering its nature. In *ITC 1435*, the court considered the nature of a subsidy received by a co-operative in relation to the future capital expenditure which would in due course qualify for the wear–and-tear allowance under section 11(*e*). The Commissioner argued that the accrual constituted a recoupment of that future expense or deduction. The court held first that no 'recoupment' could take in relation to a future expense.

Then, and without discussing the matter, it accepted that the receipt was inherently capital in nature, because (presumably) of its close association with future acquisition of a capital asset and the fact that the subsidy was an isolated event divorced from the continuing operations of the business.

What, then, was the *causa* for the accrual of the amount to the purchaser of the business?

It would seem that the purchaser's perspective, although the quantum of the accrual is directly linked to the probable future payment of a bonus, the proximate cause is the acquisition of the business, of which the undertaking to assume the bonus liability is a subordinate part and hence the accrual would be capital in nature. Yet, it can also easily be argued that the receipt effectively subsidises the payment of what is an operating expense of the business and on the analogy that it is revenue in nature.

Thus, in the same way that there are two competing causative factors for the incurral of the payment by the seller, so there are for the accrual and it is necessary to choose between them.In Clegg's view, it is likely a court would find that, on balance, the receipt or accrual on acquisition of a business of compensation for the expense of paying bonuses related to periods prior to the acquisition, is of a capital nature.

Payment of bonusses

As in the situation of the payment made by the seller of the business to the purchaser, the deductibility of the bonus expense by the purchaser depends upon whether it is more closely connected to the:

- acquisition of the business in the first instance; or
- the ongoing operations of the purchaser.

On the one hand, it can be cogently argued that had the purchaser not acquired the business (or more properly, the assets and liabilities that comprise it) no bonus would have been paid by him at all and hence the bonus expenditure is capital in nature (one difficulty with this argument is that taken to its logical conclusion, it would mean that there is no deduction for the cost of trading stock taken over in the acquisition of a business as a going concern – a proposition which is manifestly absurd).

But on the other hand, it would seem that expenditure on the employment of staff is prima facie of revenue a revenue nature and the payment of a bonus in terms of the agreement of employment undoubtedly entered into between purchaser and staff, would bear as much relevance to the future retention and happiness of that staff (in the employment of the purchaser), as it does to their past services the seller.

In CIR v *New Zealand Forest Research Institute Ltd,* the Privy Council considered this issue. Lord Hoffman said that the purchaser accepted a liability under its employment agreements with former employees, not merely to remunerate them for services to the purchaser but also to discharge obligations, either vested or contingent upon some future event, which were attributable to their previous service with the seller. It seems to their Lordships plain that, viewed in this light, the payments were capital expenditure, being part of what was paid for the acquisition of the assets.

Lord Hoffman continued as follows: It is, of course possible to imagine a case in which the purchaser of a business agrees to take on the former employees on the basis that it will honour all accrued leave entitlements without being under any obligation to the vendor to do so. In such a case, the payments are simply additional, remuneration for the services they perform for the new employer and will be a revenue expense. But…in the present case…the purchaser took on the employees…not because of a contract negotiated with its employees but rather, because it was obliged to contract with the employees on that basis…as a result of the bargain contained in the transfer agreement.

So this it seems is an authoritative answer. Clegg is of the opinion, with respect, that the reason an employer pays a bonus whose quantum is largely unrelated to the service to be rendered, is merely a *sine qua non* of that term of the agreement rather that the true causative factor of the agreement as a whole.

Much will depend upon the precise circumstances of each situation but my inclination is to say that provided the bonus is payable to employees after a period of employment by the purchaser and is conditional on that employment, then it should be properly deductible in full, notwithstanding that the quantum is in part determined in relation to a prior period and a former employer. It seems to me that the purchase of the business cannot be an over-riding factor in determining causation and that the inherent nature of the expenditure incurred in or resulting from that purchase, must be taken into account.

Conclusion

Clegg is therefore of the opinion that the receipt by the purchaser of the amount is not taxable and when the payment is made to the employees, it should (Lord Hoffman's views notwithstanding) be deductible, thereby matching its taxation in the hands of the employees.

6 RECOUPMENTS

Section 8(4)(*a*) provides that when a deduction has been granted under certain sections of the Act and the deducted expenditure is recovered or recouped, then an amount is included in income as a recoupment.

Section 8(4)(*m)* is applicable when a taxpayer has been partially or wholly relieved from a debt. Depending on the circumstances, section 8(4)(*m*) may have a fundamental impact on the seller's tax position if the purchaser takes over his liabilities. For section 8(4)(*m*) to apply, the seller must be relieved from the obligation to make payment of expenditure actually incurred and previously allowed as a tax deduction. What typically happens in a sale of business is that the purchaser assumes or takes over a liability of the seller for expenditure already deducted for tax purposes by the seller. In return, the seller either pays the purchaser for doing this or, more commonly, reduces the price of the assets purchased by the liability taken over by the purchaser. This may be done with or without the go-ahead of the creditor. Although the seller may not be released by the creditor, he nonetheless discharges the obligation to pay the expenditure by paying the purchaser to assume the obligation to pay the creditor (as in *ITC 1839*). Accordingly section 8(4)(*m*) does not apply and there is also no benefit to the seller.

It would seem that section 8(4)(*m*) may raise a concern if there is simply a net purchase price payable for the business, and no clear understanding exists that a consideration is paid or accounted for taking over the liability.

7 WORDING OF CONTRACTS

In the case of each sale of a business it is essential to analyse the agreement and to determine in substance what amounts are to be paid by the purchaser and receivable by the seller with regards to each of the assets making up the business.

Kroukamp (2006:33-39) submitted the following in her unpublished work on contingent liabilities:

One of the major considerations in structuring a sales transaction is the tax consequences to both the Seller and the Buyer. Like other terms of the agreement, what may be good for the Buyer, may not necessarily be good for the Seller, or vice versa. From a tax standpoint, the best strategy is to minimize the total taxes paid on the transaction, taking into consideration what the seller's taxes may be now and what the Buyer will ultimately have to pay.

Consideration

The consideration for the purchase of the net asset value should always form part of the agreement. In *CIR v Niko*, it was held that the purchase price in a sale of business agreement must be allocated to the different assets; otherwise the Commissioner may allocate the purchase price to the different assets, a situation that can create problems for the seller and the buyer. The allocation made by the seller should be fair and reasonable and capable of being defended.

Inclusion of the description and amounts of the assets and liabilities of the companies involved in the sale agreement is mandatory when a company listed on the Johannesburg Stock Exchange is involved in selling or transferring its assets and liabilities.

The writer identified two options for the transfer of accounting provisions and one option for not transferring the accounting provisions from the seller to the buyer during the sale of a business. These options are discussed below.

Option 1 – seller pays the buyer for taking over the liabilities

The sales agreement often provides only that the seller's assets and liabilities are taken over by the buyer and therefore the net amount is also the purchase price. The agreement often does not specify whether the assets will be paid for by the buyer or whether the liabilities will be paid by the seller.

The option is then for the buyer to pay the seller for the assets at market value and the seller to pay the buyer for taking over the liabilities, which includes the accounting provisions. The reasoning for this option is the possibility that the seller may deduct the payment for the liabilities (including the accounting provisions) as expenditure for income tax purposes. The writer is of the opinion that when payment was made by the seller to the buyer for taking over accounting provisions, the requirements of section 11(*a*) of the Act must be complied with by the seller for the seller to be entitled to a deduction.

The buyer would be taxed on these amounts received for taking over the liabilities. The payment would be included in the buyer's gross income.

A buyer who takes over a seller's liabilities, by receiving a payment for taking over the liabilities, could be entitled to claim a deduction when the liabilities and accounting provisions can fulfil the requirements of section 11(*a*) of the Act and that is if the expenditure is actually incurred, in the production of income and not of a capital nature. There can definitely be an argument for the tax deductibility of the accounting provisions and that is that the buyer took over the assets and liabilities and therefore the payment of the accounting provision (if not capital in nature) could be deductible for income tax purposes because it is closely linked to the business operation that was taken over.

Solomon SC argued in his opinion that the payment made by the seller is not incurred in the production of income. The payment is made to relieve the seller of future liabilities and not to produce income for the seller. A payment made by the seller for accounting provisions is therefore not deductible for income tax purposes.

The other argument for this option is that the amount is deductible by the seller for income tax purposes. The amount was actually incurred because the seller paid the buyer for taking over the accounting provisions. For the expenditure to be in the production of income, it can be argued that the payment was made while the seller was still trading. The third requirement for the expenditure to be deductible under section 11(*a*) of the Act is that the expenditure must not be of a capital nature. The expenditure is not of a capital nature because the purpose of the payment is not of a capital nature.

SARS allows the deduction of the payment by the seller because the seller is still trading at the time the seller makes the payment. SARS is also of the opinion that the expenditure is incurred in the production of income and there is no argument that the payment is of a capital nature.This option is not frequently used because the exchange of money (the seller paying the buyer to take over the liabilities and the buyer paying the seller for the assets) between the two parties is burdensome. The next option that will be discussed below is frequently used when the agreement states that the assets and liabilities are taken over by the buyer and the net amount is the purchase price.

Option 2 – the purchase consideration is the net asset value

Sales agreements usually state that the buyer will purchase the assets for a specified amount and assume the liabilities for another amount, the two amounts are then offset and the net purchase price is paid. The provisions are then taken over by the buyer.[44]

Option 3 – seller retains obligation

Under the third option, when the seller ceases trading and sells the business, no further deductions can be claimed under section 11(*a*) of the Act because the expense will not be incurred in the production of income. However, if the expenditure is incurred due to an obligation assumed while trading, it is still deductible under section 11(*a*) of the Act even if it is paid after trading ceases.

[44] This method was used in the *ITC 1839 case*.

In *ITC 729*, the following was held:

An employer, as part of the wages to an employee, gives him an undertaking that when he retires he will be paid a pension. That undertaking amounts to a laying out of moneys for the purposes of trade. Nor does paragraph (*g*) state that the moneys must be laid out or expended for the purpose of trade during the year for which the assessment is being made. The paragraph is in wide terms and only requires that the payment must be one which was for the purposes of trade, so that once it is established that the obligation to make the payment was for the purpose of trade, then when that obligation is discharged it remains a payment for the purposes of trade.

In *ITC 490* and *ITC 729*, expenditures were judged deductible for income tax purposes even after trading ceased (for example, after the selling of the business). When the accounting provision is retained by the seller, the expense can be deducted for income tax purposes if the requirements of section 11(*a*) of the Act are met. Because the business has been sold, no income will be available from the business to be reduced by the expenditure and the seller will possibly incur a loss that cannot be used. If the seller has income from other businesses, the loss can be used to reduce the income from the other businesses.

The seller of the business would therefore not want to retain the obligation for accounting provisions. The buyer in this option will not have taken over the accounting provisions and the buyer will therefore have no income tax implications for these provisions.

8 CONCLUSION

From the study it is apparent that one must never lose sight of the tax implications in finalising a deal. As submitted by Kroukamp (2006:3):

> Taxes can play a large part in adding value to a deal if managed properly, and conversely, destroy a deal if not handled with care.

If the taxpayer in *ITC 1839* had retained the contingent liabilities and been responsible for paying them as they fell due, the expenditure would have been deductible despite the stepping in of the disposal of the business.

On the one hand, with respect, it can be cogently argued that a taxpayer who instead relieves himself of contingent liabilities at the time of the sale by way of a deduction against the purchase price must be in an equal position. It would be difficult for the seller to have to retain staff responsibilities and other relevant infrastructure simply to deal with retained liabilities. The expenditure should retain its character of the underlying contingent liabilities whether he settles them as and when they fall due, or instead sees to it that the liabilities get assumed by someone else. As submitted in Chapter three, it could also be said that a payment to the purchaser (i.e. the set-off) may be compared with paying an insurance premium to a third party.

When the seller incurs expenditure in by way of the set-off, the mere fact that he suffered no economic expenditure should be of no consequence. Although it may be argued that the expenditure was not actually incurred, as actually incurred presupposes a cost to the taxpayer, our tax law has never indicated an economic loss to be a qualification for a deduction (also refer to *3.5.3*). The only fact that is relevant for income tax purposes is the expenditure incurred in honouring the obligations.

But on the other hand, and as decided by the court, having dealt with the rather complicated assumption that an expense has incurred, the expense was more closely connected to the sale of the business than to the prior production of income and hence not deductable.

It is unfortunate that the court did not have a view of the tax consequences of the contingent liabilities for the purchaser. But, if one considers all the arguments that has been submitted in this thesis, it would seem that an logical overall conclusion is that the contingent liabilities in the seller’s hand should not deductible, the receipt of that amount by the purchaser should not taxable and the payment by the purchaser of the contingent liabilities should be deductible when they fell due. As Clegg (2010b:72) submitted, this leads to a measure of symmetry.

Further, it must always be remembered that the wording of the sale agreement plays an important part and must be carefully reviewed before finalising the tax consequences of accounting provisions.

Another possible view, not discussed in this thesis, could be the possibility of apportionment. Accordingly recognising both the services rendered by the employees and the sale of the business as causative factors. On the authority of *Tuck v CIR*, a case dealt with accruals but the principle of which must apply equally to expenditure, a fifty-fifty apportionment might have been appropriate (Clegg 2010b:71).

As submitted Corbett CJ in by Clegg's (2010b:72) article:

> There is no equity in a tax…but there is nevertheless a measure of satisfaction to be gained from as a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus.

This study is not meant to be an exhaustive analysis of *ITC 1839* or the income tax consequences of the transfer of contingent liabilities. Instead, this study investigates *ITC 1839* and the possible tax consequences attached thereto for the seller of and also briefly looking to the purchaser.

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